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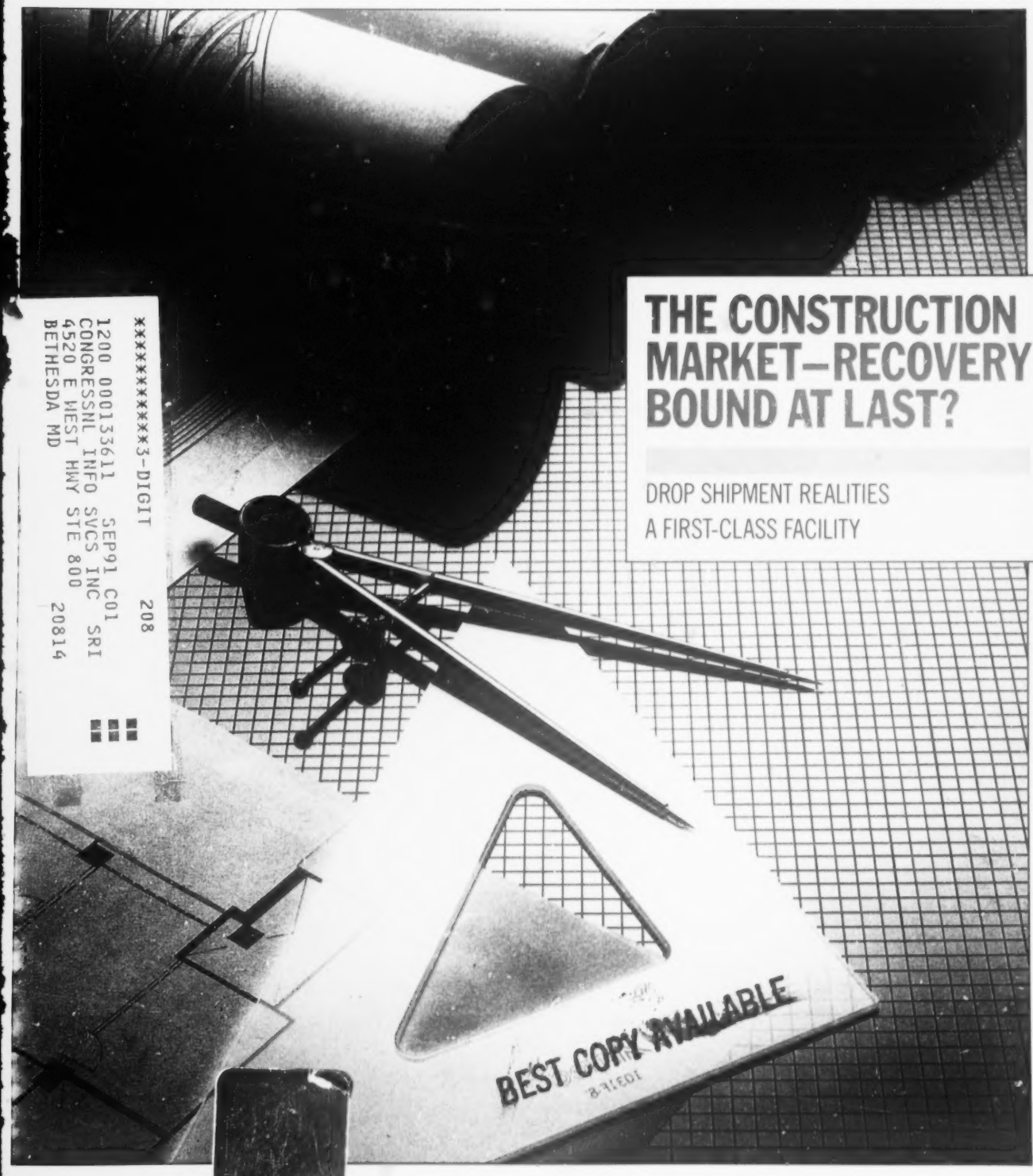

THE CONSTRUCTION MARKET—RECOVERY BOUND AT LAST?

DROP SHIPMENT REALITIES

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ELECTRICAL WHOLESALING

DECEMBER
1989

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George Christie

December is always a good time to reflect on the past year's events and to look ahead at what the coming year may bring. In this issue of ELECTRICAL WHOLESALING, we do a little of each—some reminiscing, some forecasting.

"Trends in the Making," on page 63, looks at the most significant trends in the electrical industry that started or gained momentum in 1989. These events may be harbingers of things to come in the 1990s.

For a look at the near-term future of the construction market, read "Forecast 1990," starting on page 45. The article is written by one of the leading construction industry experts in the U.S., George Christie of McGraw-Hill Information Systems Co.'s Economics Department. Christie, noted for his uncanny accuracy in predicting construction trends, discusses some recovery scenarios for 1990.

But that's not all. In this issue you can also read about changes in the 1990 National Electrical Code that offer sales opportunities for electrical distributors. And about a West Virginia distributor who has relocated his company to an expanded facility that positions it for the future.

The year ahead offers exciting challenges for us all. Here's to an enjoyable holiday season with family and friends and a healthy and profitable new year and decade.

John G. Behmke

JOHN G. BEHMKE, Publisher

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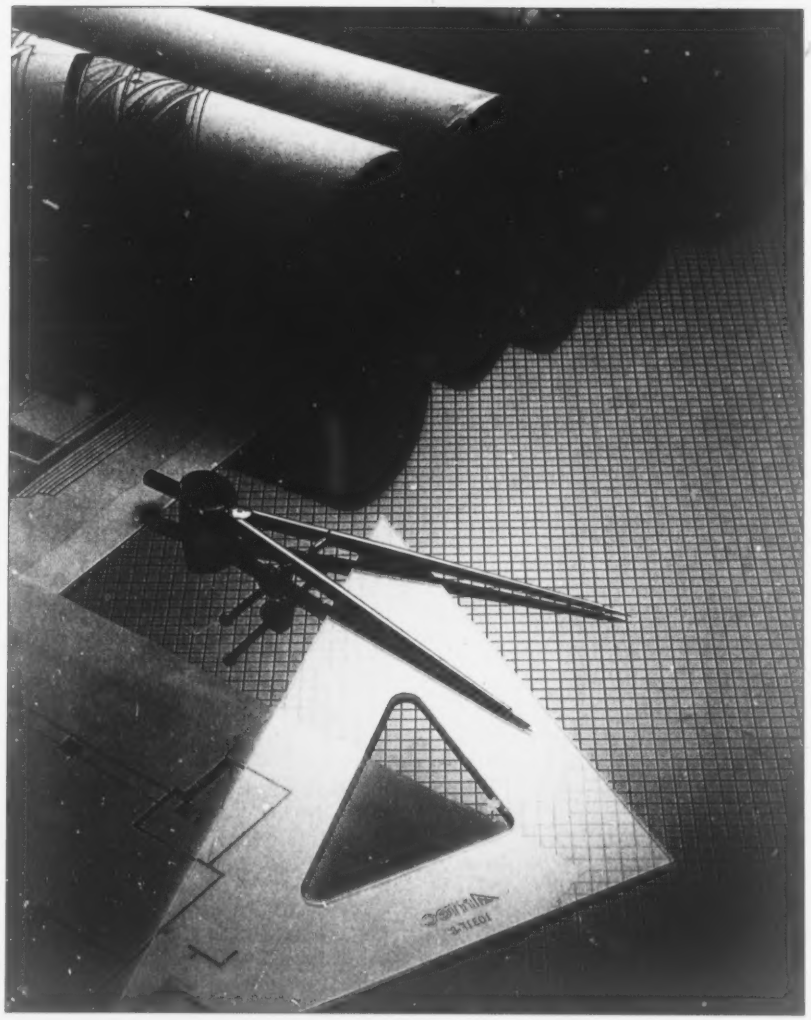
FORECAST 1990



THE 1990 DODGE/SWEET'S CONSTRUCTION OUTLOOK SHOWS A SLIGHTLY BRIGHTER PICTURE FOR 1990 THAN FOR 1989, DUE MAINLY TO HOME BUILDING.

Considering its wobbly beginning, 1989 construction contracting is coming out a bit better than it might have. This year's total of $259.8 billion will come very close to matching the previous year's value—for the second year in a row. That's in spite of indications earlier in the year that a decline was underway.

Contracting for new construction reached its peak as long ago as 1987, showing no further improvement in 1988 or 1989. But no decline, either. The word that best describes construction in 1989 is "stalled," albeit stalled at a comfortably high level.

Prepared in October 1989 by the Economics Department, McGraw-Hill Information Services Co., George A. Christie, vice president and chief economist.

COMSTOCK INC/MICHAEL STUCKEY

1990 Construction In Brief

This year's decline of interest rates is next year's recovery waiting to happen. Until recently, the temporary escalation of mortgage rates forced many families to postpone plans for home ownership. But that's changed. With conventional fixed mortgage rates averaging less than 10% in 1990, some of that deferred housing demand will resurface. That's where most of 1990's 5% improvement in construction contracting will be concentrated.

Commercial building and public works will not be contributing much to next year's recovery. Public works projects will be held to a very small gain as the need to reduce the federal deficit takes priority. Commercial building has been adjusting to high vacancy rates, the result of extensive overdevelopment during the mid-1980s. That adjustment will continue in 1990 with a further small decline of commercial construction.

So 1990's recovery will be narrowly based, confined mainly to housing, but it should be enough to get the stalled construction industry moving ahead again.

EXECUTIVE SUMMARY

This is not the way building cycles usually end. More typically, the denouement occurs in the familiar peak-and-crash sequence. Precedents abound. It happened in 1980, in 1974 and in 1970, to cite the most recent downturns. So why the soft landing this time? The key: diffusion. In the absence of a general economic recession, the long expansion of the construction sector through the mid- and late-1980s unraveled in bits and pieces instead of all at once. And that applies whether one looks at it by type of construction or by region.

Commercial building was the first to falter, and that happened as far back as 1986 when soaring office and apartment vacancy rates made it apparent that the tax-shelter boom was over even before tax reform made it official. But the collapse of the commercial market didn't do much more than slow the growth of total construction. Public works went next, in 1988, when Gramm-Rudman deficit targets clamped a lid on federal outlays for construction and other programs. But public construction was merely capped at a high level, not cut back. And there was still single-family housing, nearly one-third of total construction contracting, which refused to quit until 1988's credit squeeze took its toll. The result: lots of churning within individual building markets, resulting in stability of the total since mid-1987.

Divergent regional developments have been having a similar effect on the national numbers. From start to finish (i.e., since the 1982 low), the national total of construction contract value expanded by 65% before finally leveling off. Nevertheless, only two regions—the North Central and the West—were even close to being typical, while three others went their own ways. The South Central (alias the oil patch) was never in the game, peaking as early as 1983 and declining ever since. The Northeast and the South Atlantic, by contrast, far outpaced the others. More to the point, however, is the fact that each of the five regions turned down in a different year, leaving the impression of greater stability of the total than of its parts. Diffusion at work again.

There's a lesson in this. If the events that shaped construction markets over the past several years had occurred simultaneously instead of sequentially, the result most probably would have been the usual crash. But they didn't, so we've had the rare luxury of a soft landing instead. Now comes the task of pulling the several loose ends of the stalled construction market together again. That will happen in much the same manner as it came apart—piecemeal. There are three roads to the recovery of construction: commercial building, public construction and housing. And there are roadblocks.

Commercial building

The combination of high vacancy rates and a sluggish economy represents a formidable barrier to the recovery of commercial building in 1990. Nevertheless, there's been a change for the better in this overdeveloped market where progress has to be measured in terms of whether or not the annual declines of newly started construction are getting smaller. And they are.

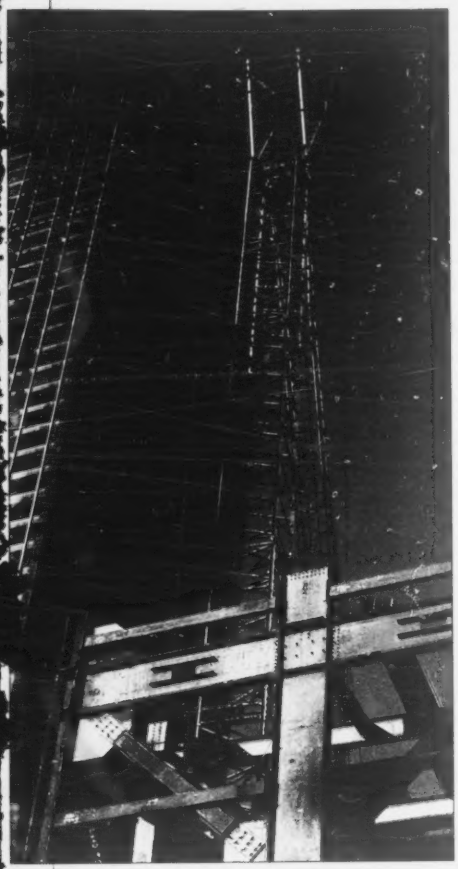
In 1989, the combined total square footage of new office buildings, apartments/condos and hotels is headed for its fourth consecutive decline—this time to a decade low of 740 million sq ft. That's 40% below the 1985 peak when the "tax shelter boom" was under a full head of steam. The good news is that 1989's decline, at 8%, is only half that of the two previous years, as contracting finally appears to be stabilizing in the range of 700 million to 800 million sq ft.

The perspective provided by hindsight now indicates that a volume of approximately 900 million sq ft per year (ideally 250 million sq ft of offices, 575 million sq ft of apartments/condos and 75 million sq ft of hotels) is about as much as the market can absorb in a good year. Any more than 900 million sq ft will drive vacancy rates up (as in 1983 through 1986). More pertinent to today's overbuilt situation: Vacancy rates can only be reduced by building less than 900 million sq ft a year.

Experience of the mid- and late-1980s shows how this works. In 1986, despite a 10% cutback in building, vacancy rates kept rising because that year's supply of new space still substantially exceeded the 900 million square foot threshold. Only after a further 16% reduction in 1987 brought contracting close to the 900 million equilibrium level did vacancy rates finally stop climbing. Still further declines of building in 1988 and 1989 below 900 million sq ft were needed to begin bringing vacancy rates down at last.

Only grudging progress has been made so far in absorbing the oversupply created during the period between the Economic Recovery Tax Act (1981) and the Tax Reform Act (1986), when accelerated depreciation overstimulated the commercial real estate market; but things are moving in the right direction.

Office vacancies currently average 18% around the nation, down from their high of 21%; apartments are now 7% vacant vs. their recent 20-year high of 8%. Hotels have shown little change, and the whole process has quite a ways to go yet. Getting the commercial building market back to a state of vi-



ability will obviously require an extended period of building less than 900 million sq ft per year.

Under such circumstances, why build even 700 million sq ft of commercial space this year or next? New buildings will continue to be built as long as they can be rented, all too often by shifting the vacancy problem to older buildings in less desirable locations. Renovation, rent concessions and/or abandonment of marginal existing structures are among the responses to continued new construction.

With so many variables in play, the "optimistic" outlook for new construction is stability at or near the 1989 volume of building for another two or possibly three years, an improvement over the steady decline since the mid-1980s. This prescription of only enough new building to keep vacancy rates coming down is hardly the stuff that recoveries are made of, however.

The 1990 estimated total of 725 million sq ft of commercial building, only slightly less than 1989's 740 million, will conceal divergent movements among offices (down), hotels (steady) and apartments (up). A short-run environment of lower interest rates and a generally sluggish economy will be giving multifamily construction an edge while simultaneously inhibiting office construction.

Public works construction

Public works contracting gives special meaning to the concept that spending for construction has reached a plateau. Since 1987, not long after the application of Gramm-Rudman deficit controls, construction of infrastructure projects has been stonewalled at $43 billion per year. This contrasts with its strong and steady growth through the middle of the 1980s, from a level of only $25 billion at the start of the decade. Since the plateau was reached, even the relative shares of transportation work (roads, bridges, mass transit) and

1990 CONSTRUCTION POTENTIALS

National estimates for 1990 show small upturn overall

	CONTRACT VALUE			FLOOR AREA		
	1989 PRELIMINARY	1990 FORECAST	PERCENT CHANGE	1989 PRELIMINARY	1990 FORECAST	PERCENT CHANGE
ALL CONSTRUCTION	$259,800	$273,500	+5%			
NONRESIDENTIAL BUILDINGS, TOTAL	89,275	87,750	-2%	1,255	1,175	-6%
COMMERCIAL AND MANUFACTURING, TOTAL	53,475	49,600	-7%	910	815	-10%
OFFICE BUILDINGS	20,675	19,025	-8%	220	195	-11%
STORES AND OTHER COMMERCIAL	24,125	22,100	-8%	540	475	-12%
MANUFACTURING BUILDINGS	8,675	8,475	-2%	150	145	-3%
INSTITUTIONAL AND OTHER, TOTAL	35,800	38,150	+7%	345	360	+4%
EDUCATIONAL	13,875	14,550	+5%	134	137	+2%
HOSPITAL AND HEALTH	8,250	8,750	+6%	69	71	+3%
OTHER NONRESIDENTIAL BUILDINGS	13,675	14,850	+9%	142	152	+7%
RESIDENTIAL BUILDINGS, TOTAL	122,850	136,900	+11%	2,190	2,375	+8%
ONE-FAMILY HOUSES	93,375	106,325	+14%	1,655	1,835	+11%
MULTIFAMILY HOUSING	23,400	24,525	+5%	465	472	+2%
NONHOUSEKEEPING RESIDENTIAL	6,075	6,050	—	70	68	-3%
NONBUILDING CONSTRUCTION, TOTAL	47,675	48,850	+2%			
PUBLIC WORKS, TOTAL	43,175	44,150	+2%			
TRANSPORTATION CONSTRUCTION	24,825	25,250	+2%			
ENVIRONMENTAL CONSTRUCTION	18,350	18,900	+3%			

Construction contract value in millions of dollars.
Floor area in millions of square feet.

GE LAMP

environmental projects (water resources, waste treatment facilities) have been frozen at 60%:40%. If any change is taking place in this catatonic construction market, it is the barely perceptible transfer of control from the federal agencies to the state and local governments.

At the federal level, the ongoing process of deficit reduction, along with the need to absorb some new initiatives (e.g., the savings and loan bailout, the war on drugs) will claim most or all of next year's projected revenue growth of between $50 billion and $75 billion. Even after some token reductions of defense spending and entitlement programs, the President's "no new taxes" pledge leaves little room for increased funding of federal public works programs in 1990. Perhaps the most that can be said is that the combined total of the construction programs of the Department of Transportation (DOT), Environmental Protection Agency (EPA), et al., is (so far) not slated for cuts.

Is there opportunity for increased public works spending in 1990 via state and local governments? Some, but not much. State governments are in better financial condition than the federal government in several ways: Collectively, state budgets are in surplus; most states have been raising taxes this year; many keep separate operating and capital budgets. In addition, states are setting up revolving loan funds to replace EPA's sewage treatment construction grants as required by the Clean Water Act (1987). Although state expenditures reflect a different blend of commitments that in many ways are as demanding as federal priorities (e.g., education and welfare vs. military preparedness and Social Security), their surplus position nevertheless implies a small but fundamental flexibility that does not exist in Washington.

In 1990, contracting for public works projects will not differ significantly from the past few years, either in its total value or in the types of work to be done. Governmental gridlock will continue to stand in the way of a breakout as state/local contracting, with the help of a friendlier bond market, only slightly more than offsets federal budgetary restraint. With total contract value inching above $44 billion in 1990, both transportation and environmental construction will be held to nominal gains too small even to keep pace with inflation.

1990 CONSTRUCTION POTENTIALS

■ The regions show mixed activity by market

REGION/CONSTRUCTION TYPE	CONSTRUCTION CONTRACT VALUE 1989 PRELIMINARY	1990 FORECAST	PERCENT CHANGE
NORTHEAST: TOTAL CONSTRUCTION	$50,125	$51,800	+3%
NONRESIDENTIAL BUILDING	18,250	17,900	-2%
COMMERCIAL AND MANUFACTURING	10,750	10,075	-6%
INSTITUTIONAL AND OTHER	7,500	7,825	+4%
NONBUILDING CONSTRUCTION	10,525	10,725	+2%
RESIDENTIAL BUILDING	21,350	23,175	+9%
ONE-FAMILY HOUSES	15,000	16,750	+12%
MULTIFAMILY AND NONHOUSEKEEPING	6,350	6,425	+1%
NORTH CENTRAL: TOTAL CONSTRUCTION	53,575	56,600	+6%
NONRESIDENTIAL BUILDING	20,600	20,575	—
COMMERCIAL AND MANUFACTURING	13,025	12,150	-7%
INSTITUTIONAL AND OTHER	7,575	8,425	+11%
NONBUILDING CONSTRUCTION	10,025	10,450	+4%
RESIDENTIAL BUILDING	22,950	25,575	+11%
ONE-FAMILY HOUSES	17,500	20,100	+15%
MULTIFAMILY AND NONHOUSEKEEPING	5,450	5,475	—
SOUTH ATLANTIC: TOTAL CONSTRUCTION	57,650	60,225	+4%
NONRESIDENTIAL BUILDING	18,300	17,625	-4%
COMMERCIAL AND MANUFACTURING	10,700	9,750	-9%
INSTITUTIONAL AND OTHER	7,600	7,875	+4%
NONBUILDING CONSTRUCTION	8,350	8,550	+2%
RESIDENTIAL BUILDING	31,000	34,050	+10%
ONE-FAMILY HOUSES	23,375	25,975	+11%
MULTIFAMILY AND NONHOUSEKEEPING	7,625	8,075	+6%
SOUTH CENTRAL: TOTAL CONSTRUCTION	31,950	34,500	+8%
NONRESIDENTIAL BUILDING	11,425	11,625	+2%
COMMERCIAL AND MANUFACTURING	5,850	5,875	—
INSTITUTIONAL AND OTHER	5,575	5,750	+3%
NONBUILDING CONSTRUCTION	8,500	8,625	+1%
RESIDENTIAL BUILDING	12,025	14,250	+19%
ONE-FAMILY HOUSES	10,375	12,425	+20%
MULTIFAMILY AND NONHOUSEKEEPING	1,650	1,825	+11%
WEST: TOTAL CONSTRUCTION	66,500	70,375	+6%
NONRESIDENTIAL BUILDING	20,700	20,025	-3%
COMMERCIAL AND MANUFACTURING	13,150	11,750	-11%
INSTITUTIONAL AND OTHER	7,550	8,275	+10%
NONBUILDING CONSTRUCTION	10,275	10,500	+2%
RESIDENTIAL BUILDING	35,525	39,850	+12%
ONE-FAMILY HOUSES	27,125	31,075	+15%
MULTIFAMILY AND NONHOUSEKEEPING	8,400	8,775	+4%

Construction contract value in millions of dollars.

Northeast consists of Conn., Me., Mass., N.H., N.J., N.Y., Pa., R.I., Vt.; North Central consists of Ill., Ind., Ia., Kan., Mich., Minn., Mo., Neb., N.D., Ohio, S.D., Wis.; South Atlantic consists of Del., D.C., Fla., Ga., Md., N.C., S.C., Va., W.Va.; South Central consists of Ala., Ark., Ky., La., Miss., Okla., Tenn., Tex.; and West consists of Alaska, Ariz., Calif., Colo., Hi., Id., Mont., Nev., N.M., Ore., Utah, Wash., Wyo.

Housing and institutional building

Ever since 1983, when the Federal Reserve celebrated its victory over double-digit inflation by liberating the economy from double-digit interest rates, one-family home building has been an outstanding performer.

Institutional building has run a close second. Being the types of building that are most sensitive to credit conditions, these are the ones that stand to benefit most from current developments in the money market.

Housing. While commercial building was having its boom and bust in the mid-1980s, and while public works construction was running into the wall of deficit reduction a little later on, one-family home building just kept getting

COMSTOCK INC./MAC WERNER

better and better as the decade wore on. Starting from a depressed annual average of 700,000 units in the early years (1980-1982), one-family housing starts advanced to an average of 985,000 units during the middle years (1984-1986) and then climbed to 1,025,000 units in the closing years (1986-1989). (Note: All references to housing starts or dwelling units are based on F.W. Dodge terminology. Commerce Department data, which use somewhat different definitions of single and multifamily housing, nevertheless show parallel year-to-year changes.)

With most of the nation's population growth concentrated in the 35 to 55 age bracket—the "age of acquisition"—owner-occupied housing is enjoying strong demographic support at a time when total household formation is waning. Census data show that at the age of 35, half of family heads are renters; but by age 55, more than three-quarters of them become homeowners. Yet, as the early years of this decade demonstrated, demographic support doesn't count for much without a smoothly functioning mortgage market to convert potential into effective demand.

The accompanying chart illustrates the relationship between one-family housing starts and mortgage rates since 1980, a period brief enough that the longer-run determinants of housing demand (demographics, affordability, social values, etc.) can be considered temporarily fixed. It reveals much about the present state of the home building market:

- Within the fairly wide range of 10% to 15% mortgage rates, housing starts can swing from a low of 700,000 units to a bit more than 1,000,000 units along a curve that approaches 1,100,000 units as the short-term upper limit set by the combination of demographics and affordability.
- Because full potential is rarely achieved, recent experience suggests that under favorable credit conditions, the practical potential for one-family housing starts is currently about 1,050,000 units.

What the chart does not show is another short-run phenomenon—the normal delay of the response of housing demand to changes in the level of interest rates. If the reaction to rising mortgage rates were more direct, for example, housing starts would have declined sooner than they did in 1988 when mortgage rates began rising as early as the second quarter. The way it turned out, however, builders' response to 1988's higher rates wasn't evident until the first half of 1989. By that time, mortgage rates had already peaked and were coming down again, and the lag began to work in the other direction. Although mortgage rates started to fall in the spring of 1989, housing starts weren't ready to recover until late in the year.

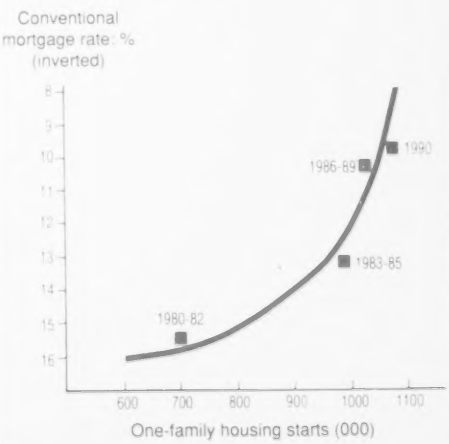
There's a rationale for this lag. It's the ritual that links the money market with the building business. As rates begin to fall, the initial reaction of potential borrowers is to wait and see. Even when home buyers are convinced that rates won't go much lower and are ready to borrow, builders aren't ready to build. They'd rather reduce their inventories of newly finished but unsold homes, which tend to swell during periods of rising interest rates. Not until inventories are down to a desirable six-month supply do builders take out permits and start new homes. The whole sequence—falling interest rates/existing home sales/permits/starts—can take as much as half a year. In the current situation it means that despite improving credit conditions through most of 1989, this year's total of one-family housing starts will reach only an estimated 975,000 units, leaving an important carryover of deferred demand.

In 1990, with mortgage rates averaging 9.75%, the realization of normal potential along with a partial carryover of deferred 1989 demand could lift one-family building to 1,075,000 units—a gain of 10%. The 1990 spurt of one-family home building may be short-lived, however. Before the end of the year rates will be moving up again; and without the benefit of deferred demand, one-family housing starts will settle back to their 1987/88 levels of about 1,025,000 units.

Institutional building. To appreciate the parallel between one-family housing and institutional building, it is only necessary to substitute municipal bonds for mortgages and to exchange the ends of the population "pyramid" for its middle. Growth of the population in the "under 15" and "over 65" age brackets is second only to the 35 to 55 year olds. Elementary schools and health care facilities are the obvious linkages.

Through most of the 1980s, contracting for educational, health and public administration buildings has shown vigorous 5% annual growth (in square footage), a sharp contrast to the declining trend of the 1970s when the school-age population was shrinking. A recent interruption of this growth of institutional building during the 1988/89 period of credit restraint is bound to be temporary. Renewed expansion is anticipated in 1990 as this market's underlying strength responds to lower interest rates.

Lower rates, more housing



The outlook for 1990...

Before long, contracting for new construction will be lifting off the plateau it has been confined to for the past three years. Despite a lack of short-term potential in either the overbuilt commercial market or the deficit-dominated public sector, a recovery of home building, backed up by improvement of institutional construction, will be enough to break the recent deadlock.

It is important, however, not to lose sight of the fact that little has changed concerning the generally bleak environment for the construction industry except for one very important thing: the cost of credit. For now, that's sufficient. It is almost axiomatic that a decline of interest rates, following a period of temporary escalation, will encourage fuller realization of the demographic potential in the credit-sensitive building markets. All that needs to happen has already happened. Favorable demographics for these markets are solidly established. Interest rates have fallen. Recession does not pose a serious threat. Under these conditions, it is reasonable to expect that 1990 will bring more than a normal volume of housing and institutional building, including an additional "dividend" as some of 1989's unrealized demand is recaptured.

A volume of 1,525,000 total housing starts in 1990, with gains in both one-family and multifamily units, will be an 8% improvement over 1989's depressed level of building. With inflation in residential building costs of between 3% and 4%, the potential for improvement in residential construction contract value next year is slightly on the high side of 10%. Institutional building, which is not as volatile as housing, will respond in its own way to the stimulus of lower financing costs—with a gain of between 5% and 10% in 1990.

For the time being, that's all there is. But it is enough to produce the first advance in total construction contract value since 1987. Because housing and institutional building together make up roughly 60% of total contract value, their combined 1990 gain of almost 10% will have a "bottom line" impact of 5% next year as total construction contract value rises from its $260 billion plateau to a new high of $273 billion.

...and 1991

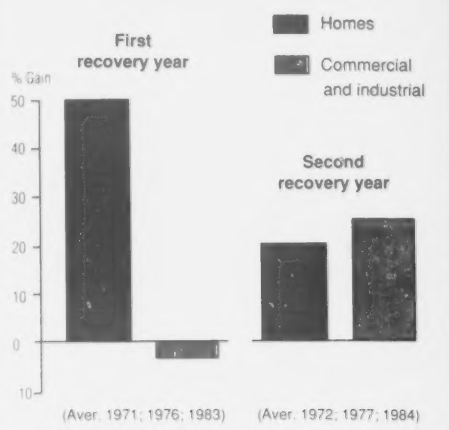
The case for moving ahead in 1990 is based largely on falling interest rates. The 1989 decline of interest rates is a 1990 housing recovery just waiting to happen.

And then what? If the only difference between 1989 and 1990 is more favorable credit conditions, all that is happening is the shifting of some 1989 housing demand into 1990. What does this say about 1991? What does it say about nonresidential construction? The moment of truth for this newly developing expansion will arrive in 1991, its critical sophomore year. This is when 1990's tentative advance will either pick up momentum or burn out. It is when we will discover whether or not we have a real recovery going. Two possible scenarios illustrate different outcomes of next year's positive developments in construction contracting.

Scenario No. 1: Business as usual. Analysis of the recovery/expansion phase of building cycles over the past two decades reveals a consistent sequence. Recovery typically takes hold first in home building in response to falling interest rates. This much of the "standard" recovery pattern corresponds closely with the outlook for next year.

In the second year, the early recovery of residential building is usually reinforced by an expansion of nonresidential (i.e., commercial and industrial) construction, as the accompanying chart shows. The development of this second-stage support is more complex than the interest rate/housing reflex. Certainly the longer time needed to get larger nonresidential projects underway plays a part. So, too, does the time-honored principle that business capital spending, of which commercial and industrial building is a component, typically lags the dynamics of the economy at large.

What typically happens in a recovery



In the "business as usual" scenario, 1991—the critical second year—would bring side-by-side increases of housing and nonresidential building, resulting in an acceleration of the first year's gain and forming a base for several years of continuing cyclical expansion. That's the way it has worked for at least the past two decades.

Scenario No. 2: Second stage burnout. This alternative to "business as usual" recognizes two events of the 1980s whose consequences will be distorting construction markets well into the 1990s. One is the Economic Recovery Tax Act of 1981, which greatly overstimulated commercial building by its accelerated depreciation provision. Although full-term depreciation was restored by tax reform, ERTA's backlash—stubbornly high vacancy rates—will depress new building for years to come. The other event is the Deficit Control Act (1985), more familiarly known as the Gramm-Rudman Act. A reaction to runaway deficits, Gramm-Rudman has effectively frozen funding for federal construction programs. Because of this "baggage" of the 1980s that must be carried into the 1990s, a sizable block of nonresidential construction may not be available to provide the usual second-stage boost in 1991.

Like the first scenario, this one says that 1990 can be relied upon to deliver

THE 1990s IN CONSTRUCTION

■ Challenges and opportunity

At the start of 1989, the construction industry faced three major problems. One of them—artificially high interest rates—is already resolved, and the prospect of improved housing and institutional building is the essence of the 1990 outlook.

Another problem, the glut of commercial buildings, is by now partially resolved. A 40% cutback of new construction since 1986 means that the hardest part of the adjustment to the mid-1980's overbuilding is behind us. A third problem, the scarcity of public funds for construction programs, is farthest from being solved.

What's needed is a blend of deficit reduction, user fees, reordering of federal priorities and increased participation by state and local governments. Finding ways to maintain and develop the nation's infrastructure could well be the construction industry's greatest challenge in the coming decade.

an above-average volume of housing as some of 1989's deferred demand is salvaged. But that is where the similarity ends. By 1991, housing starts will ease back to the level prevailing in 1987/88 and, more important, the reinforcement of nonresidential building required to keep total construction advancing through the second year of recovery will be absent. In this by-no-means-worst-case scenario, recovery loses whatever initial momentum it had by 1991 and stalls. Total construction contracting settles back to its former plateau to wait out the resolution of the problems that are holding back the development of the commercial and public works markets.

Making a choice between these two extensions of 1990's developments is the task of next year's construction outlook. By then, conditions in the pivotal nonresidential sector will be clearer than they are at present. For the time being, though, it is hard to avoid the conclusion that 1991 will develop more along the lines of the second scenario, which recognizes that some fundamental handicaps left over from the recent past have not gone away. On the other hand, no severe crash (the "worst-case" outlook) is on the horizon. Instead, the construction industry appears headed for nothing worse than high-level stagnation until the distortions of the 1980s are gradually sorted out. □

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In The Background

The initial effects of another dose of monetary restraint are wearing off. The economy's growth has been slowed, inflation has been tamed and interest rates are on their way down again. What remains is the final chapter of a delicate and apparently successful exercise in fine tuning: some lingering deceleration of economic activity as the lags play out, and following that, a period of renewed, if not particularly vigorous, expansion.

Because monetary policy is more effective at restraining economic activity than it is at stimulating expansion, the hardest part lies ahead. If the gestation period for monetary policy is roughly three quarters, the Federal Reserve's shift to stimulus should have economic activity (as measured by real GNP) accelerating by the first quarter of 1990, with continuing improvement throughout the balance of next year. That would follow progressive weakness in the closing months of 1989, as growth winds down to about 1% (vs. 3.7% in 1989's opening quarter). If all goes according to the script, 1990 will be a mirror image of 1989—weak beginning/stronger finish. On an *annual* basis, however, both 1989 and 1990 will show substandard growth, the price of keeping inflation below 5%.

Next year's potential for GNP growth—roughly 2% over 1989's output—will rely heavily on above-average residential building and continued expansion of export markets as business capital spending and consumption lag the recovery. Government spending, as might be expected, will contribute little to the economy's revival. Inflation, as measured by the Consumer Price Index, will remain close to 4% in 1990 after averaging just under 5% in 1989. The year-by-year steady decline of unemployment (from its 1982/83 high of 9.5% to this year's 5.25%) will be temporarily interrupted, though not seriously.

No measure of economic activity is more critical to the outlook for construction than interest rates. The most recent excursion of the conventional fixed mortgage rate, with the central bank as its tour guide, began in the second quarter of 1988. From a low of 10.1%, the basic mortgage rate was nudged to a peak of 11.2% late in the first quarter of 1989. After receding gradually through April, the mortgage rate then plummeted in May and June, breaking through the 10% level in July.

Although the Fed appears to have adopted a position of neutrality in the money markets by midyear, the mortgage rate is likely to continue to decline through the remainder of 1989 as the slowing pace of economic activity generally inhibits loan demand. It is assumed that the conventional mortgage rate will stabilize at 9.75% during the first half of 1990 and advance in the second half as demand strengthens. Compared with an average of 10.4% for 1989, the conventional fixed mortgage rate is forecast to average 9.8% in 1990—the first single-digit year since 1978!

Beyond the fluctuation of interest rates brought about by on-and-off monetary restraint in the continuing attempt to strike the proper balance between growth and inflation, there will be a barely perceptible downward trend of long-term interest rates in the 1990s as the federal deficit is reduced in small and difficult decrements. Progress in deficit reduction is expected to be somewhat better than the excessively conservative projections of the Congressional Budget Office, which foresees no reduction at all between 1990 and 1993. At the other extreme are the Administration's overly optimistic projections based on unrealistic revenue expectations. An achievable schedule of deficit reductions of approximately $10 billion per year implies persisting inflationary pressure from fiscal operations, a generally high level of interest rates and an average annual increase of federal outlays that exceeds the going rate of inflation by about 1%.

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